Berman v. Commissioner, 163 T. C. No. 1 (U. S. Tax Court 2024)

In Berman v. Commissioner, the U. S. Tax Court ruled that taxpayers who sold stock to an ESOP under an installment agreement and elected to defer gain under Section 1042 could still use the installment method under Section 453 to report gains. The court reconciled these provisions, allowing gain recognition to be deferred until payments were received, impacting how gains are reported and deferred in tax planning involving ESOPs and installment sales.

Parties

Edward L. Berman and Ellen L. Berman were petitioners in Docket No. 202-13, and Annie Berman was the petitioner in Docket No. 388-13. The respondent in both cases was the Commissioner of Internal Revenue.

Facts

In 2002, Edward and Annie Berman each sold shares of E. M. Lawrence, Ltd. to the E. M. Lawrence Employee Stock Ownership Plan (ESOP) for $4. 15 million, receiving promissory notes as payment. They reported making Section 1042 elections on their 2002 tax returns to defer recognition of the gains. In 2003, they purchased floating rate notes (FRNs) as qualified replacement property (QRP) within the replacement period but later engaged in Derivium 90% loan transactions, effectively selling the FRNs. The Commissioner issued notices of deficiency for 2003-2008, asserting that the entire deferred gain should be recognized in 2003 due to the sale of the QRP.

Procedural History

The Commissioner issued notices of deficiency to the Bermans for tax years 2003 through 2008, asserting unreported long-term capital gains due to the sale of QRP in 2003. The Bermans filed petitions with the U. S. Tax Court for redetermination. Cross-motions for partial summary judgment were filed, focusing on whether the Bermans could use the installment method under Section 453 to report the recapture of gains triggered by the disposition of their QRP in 2003.

Issue(s)

Whether taxpayers who elected to defer gain under Section 1042 for the sale of stock to an ESOP in an installment sale are precluded from using the installment method under Section 453 to report the recapture of those gains upon disposition of the qualified replacement property?

Rule(s) of Law

Section 453 of the Internal Revenue Code mandates that income from an installment sale be taken into account under the installment method unless the taxpayer elects otherwise. Section 1042 allows a taxpayer to defer recognition of gain on the sale of

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qualified securities to an ESOP if qualified replacement property is purchased within the replacement period. The court must reconcile these provisions, as Section 1042(e) states that gain shall be recognized upon disposition of QRP "notwithstanding any other provision of this title. "

Holding

The court held that the Bermans' Section 1042 elections did not preclude them from using the installment method under Section 453 to report gains from the ESOP stock sales. The court determined that the gains "which would be recognized" under Section 1042(a) in the absence of the election were subject to the installment method, and thus, the timing and amount of gain recognition were to be determined under Section 453 when payments were received.

Reasoning

The court reconciled Sections 1042 and 453 by interpreting the phrase "which would be recognized" in Section 1042(a) to refer to the gain that would be recognized absent the Section 1042 election, which in an installment sale scenario would be governed by Section 453. The court noted that Congress was presumed to be aware of the operation of Section 453 when enacting Section 1042. The Bermans did not elect out of Section 453, and thus, the installment method applied to the timing of gain recognition. The court further held that the basis of the QRP should be adjusted under Section 1042(d) by the amount of gain deferred, and upon disposition of the QRP, the gain on the deemed sale was calculated accordingly. The court's decision was based on statutory interpretation, the legislative history of Section 453, and the policy of allowing taxpayers to defer gain recognition until payments are received, consistent with the installment method.

Disposition

The court granted the Bermans' motion for partial summary judgment and denied the Commissioner's motion, ruling that the Bermans could report the recaptured gains under the installment method for the years in which they received payments.

Significance/Impact

The decision in Berman v. Commissioner clarifies the interplay between Sections 1042 and 453, providing guidance on how gains from installment sales to ESOPs can be deferred and reported. This ruling has significant implications for tax planning involving ESOPs, as it allows taxpayers to defer recognition of gains until payments are received under the installment method, even if they have made a Section 1042 election. The case underscores the importance of considering both statutory provisions in structuring such transactions and may influence future tax court decisions and IRS guidance on the application of these sections.

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